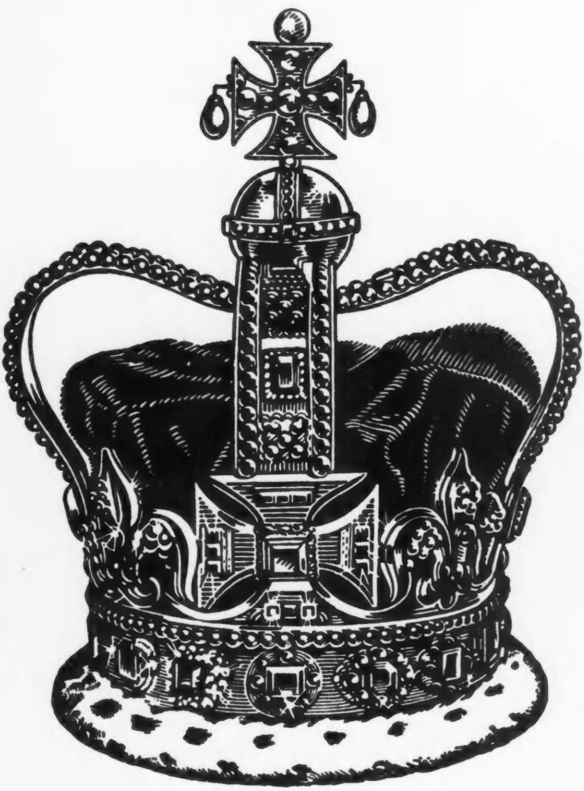
The Canadian Chartered Accountant



EIIR

THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS

JUNE 1953

$5.00 A YEAR - 50c A COPY

PUBLICATIONS

of

The Canadian Institute of Chartered Accountants

The Canadian Chartered Accountants

and

The Tax Review

(Published Monthly)

$5.00 a year

Permanent Binder for The Tax Review $3.00

Brochures

Audit Procedure for the Junior Audit Clerk (3rd Edition, Feb. 1949) 140 pp.	1.00
Budgetary Control by E. S. La Rose (1947) 51 pp.	.50
Principles of Bookkeeping by J. R. M. Wilson	.50
To Incorporate or Not To Incorporate by J. A. McColl (Mar. 1950) 6 pp.	.25

Examination Papers

1946, 1947, 1948, 1949, Intermediate and Final	.35 each
1950, 1951, 1952, Intermediate and Final	.50 each

Examination Problems and Solutions

Volume VII	.50
Volumes VIII, IX, X, XI (solutions only)	.50 each

Accounting and Auditing Research Bulletins

(available in English and French)

No. 1	A Statement of Standards of Disclosure in Annual Financial Statements of Manufacturing and Mercantile Companies	.15
No. 2	A Statement of the Minimum Standards of Professional Practice which Should Apply in respect of Prospectuses	.15
No. 3	The Accounting Treatment of Income Taxes in Some Special Circumstances	.15
No. 4	Accounting for Bad Debt Losses	.15
No. 5	The Meaning of the Term "Cost" as Applied to Inventory Valuation	.15
No. 6	The Auditor's Report	.15
No. 7	The Auditor's Responsibility for the Validity of the Inventory Figure	.15
No. 8	"Deferred" Depreciation	.15
No. 9	The Use of the Term "Reserve" and Accounting for Reserves (English only)	.15
Binding Folder for Research Bulletins		.15

The Canadian Institute of Chartered Accountants

10 Adelaide Street East — Toronto, Ont.


IBM

The Canadian
Chartered Accountant

VOLUME 62 JUNE 1953 NUMBER 6

PUBLISHED MONTHLY

By The Canadian Institute of Chartered Accountants
G. P. KEEPING, F.C.A., *Chairman, Editorial Committee*
Editorial and Business Offices, 10 Adelaide Street East, Toronto, Ontario
MELVILLE PIERCE, *Managing Editor* JEAN VALE, *Assistant Editor*
Advertising Representative: E. L. VETTER, *10 Adelaide St. E., Toronto, Ont.* EM. 8-1095

Subscriptions to *The Canadian Chartered Accountant* and *The Tax Review*: $5.00 a year. Additional subscriptions to *The Tax Review* $3.00 a year.

Single copies 50c. Single copies of *The Tax Review* 50c.

A volume index to *The Canadian Chartered Accountant* is published semi-annually and to *The Tax Review* annually.

Opinions expressed in articles and comment are not necessarily endorsed by The Canadian Institute of Chartered Accountants.

Advertising rates on request

Authorized as second class mail by the Post Office Department, Ottawa

SWEETNESS and LIGHT

By Jay Vee

Where It Hurts Most

IF by any chance you have been crying the income-tax blues lately, console yourself with this little gem from the British *Hansard* as reported in *Taxation*, April 11, 1953:

Mr. Peter Freeman asked the Chancellor of the Exchequer what total income will bring an additional £1,000 per annum net income to a person already receiving £10,000 per annum.

Mr. R. A. Butler: £41,000.

Side, Back or Peameal?

FROM the April issue of *The Accountants Magazine*, published by the Institute of Chartered Accountants of Scotland, comes this interesting problem:

Glasgow, March 24, 1953

Sir: I discovered the other day, to my great surprise, a mathematical blank in my mind and, I may add, the minds of my partners and staff.

Recently, I asked a London finance house if they would be prepared to purchase a block of new H.P. debts, repayment being spread equally over the next 12 months, amounting to £100,000 and "Combien?" Yes, they replied, and at 7 per cent. After some laughter on my part I appealed to them not to be silly and to tell me in fact how much. They said they would give £93,000 now, which was £100,000 less 7 per cent, for the right to collect at the end of each month £8,333 over the next 12 months (a total of £100,000). To which I replied that not only were they not advancing £100,000 but only £93,000 but that their capital was being repaid monthly.

Returned to my office, I thought I would

work out the effective rate per cent being earned by the finance house. Having taken paper and pencil it was not long before my pencil faltered, and then it stopped altogether. I could easily enough make a rough and ready calculation of average capital employed and strike a percentage but C.A.'s are not "rough and ready" in their work. Thereafter, and slightly worried at my failure, I consulted my partners. After smilingly assuring me of how simple they would find the problem they, ultimately, confessed it was too much for them. Thereupon, I consulted the office staff, particularly those who had taken Actuarial Science, but with no more success. Finally (because I do not mind being spoon-fed) I pled with an actuary to tell me the answer, which he very kindly worked out for me, although I am still not sure I entirely follow it.

Many of your readers will no doubt smile and feel certain of the ease with which they can ascertain the effective rate. Very well, I make them an offer. Trusting it is their unaided work and that they are not actuaries, I shall be glad to receive worked out solutions and to put the correct ones (if any) in a hat. I shall then invite the first lady in the profession in the West of Scotland, Miss Craig, who favours none and loves all of us equally, to draw the winner and (I am serious) present him or her with a tin of American sliced bacon.

A. G. McBain

We would gladly make the same offer but how would we know the correct rate when we see it?

Never The Twain Shall Meet?

WE have just learned from *The Journal of Accountancy* that Henry Schindall, a New York C.P.A., has written a historical novel of the days of the American Revolution entitled "Let the Spring Come". But we note with a peculiar mixture of relief and disappointment that the elements which keep the story in motion, namely women and unscrupulous *nouveaux riches*, are expressly classified by the Journal as "non-accounting subjects".

ve

C

Al
ye
Ac
sel
of
ter
the
sul

do
to
(P

one
del
the
tut
the
tha
sist
in
Poi
cip
qui
of
in
ing

The Canadian
Chartered Accountant

VOLUME 62 JUNE 1953 NUMBER 6

COMMENT AND OPINION

Mr. Abbott and Pension Plans for the Self-Employed

ON another page we print the comments made by Finance Minister Abbott in explanation of his refusal this year to introduce into the Income Tax Act a retirement pension plan for the self-employed. He has indicated some of the difficulties in the way and extended an invitation to the members of the legal and accounting professions to subject his remarks to a critical analysis.

The principal reason for Mr. Abbott's doubts appear from the reply he made to some critical remarks of Mr. Fleming (P.C. Eglinton). Said Mr. Abbott:

> My real basis of distinction [between pensions for employed persons and pensions for the self-employed] is why should one form of saving be singled out for tax postponement? That is the fundamental consideration.

The question is by no means a new one. It was the subject of considerable debate more than a century ago when the British Income Tax Act was reinstituted after a lapse of 25 years following the Napoleonic Wars, and we believe that discussion has never altogether desisted since that time. John Stuart Mill in the first edition of his *Principles of Political Economy* argued that the principle of equality of tax distribution "requires that a person who has no means of providing for old age, or for those in whom he is interested, except by saving from income, should have the tax remitted on all that part of his income which is really and *bona fide* applied to that purpose". That may be going a little far nowadays. One result of the agitation in Great Britain was the exemption of premiums on life insurance policies and deferred annuities in Mr. Gladstone's famous Budget of 1853 to the extent of one-sixth of the taxpayer's income, and to this day that form of exemption persists in Great Britain. The whole question is, however, once again in the forefront there, being the subject of investigation by a Parliamentary commission headed by Mr. Millard Tucker. The report of that committee is eagerly awaited by the accounting profession in Great Britain, and will undoubtedly be helpful in the future discussions on the question which will take place here.

Mr. Abbott's invitation to the accounting profession to study this question will assuredly be accepted. It is the professional classes, debarred by the nature of their work from the relief open to employed persons and proprietors of businesses, who stand most in need of some solution to a problem which has become acute with the enormous increase in rates of taxation since 1939.

How Our Tax Brief Fared

THE C.I.C.A. and the Canadian Bar Association have some cause for gratification that Mr. Abbott accepted so many of their recommendations for

amendments to the Income Tax Act. It would appear in fact (though we have no accurate statistics on the matter), that the batting average on the joint brief this year has been the highest yet. The figure? Just under .300, according to our calculation, which is respectable enough.

At the same time it must be conceded that we did not get to first base with most of our more important recommendations, in particular those designed to bring the accounting and tax concepts of business income closer together. The Government was apparently unable to persuade itself of the wisdom of our recommendation that the ascertainment of business income could safely be left to be determined by well-recognized accounting principles. Accordingly, the Act is now to contain a long and complicated enactment governing an important part of the method of computing business profits. We have more to say about that below. In practically every other country in the English-speaking world greater trust and reliance is placed on the accounting profession than appears to be the case in our own.

Tax "Reserves" (?)

THE recent amendment to the Income Tax Act will permit the deduction of amounts described as "reserves" (1) for prepaid goods and services that will have to be delivered or rendered in a year succeeding the taxation year; (2) for prepaid rent or hire for land or a ship; (3) for containers that will have to be redeemed in a year following the taxation year; (4) for the profit portion of the unpaid price of property which is not due for two years from the date of sale; (5) for unearned insurance premiums except on life insurance; and (6) for unearned commissions on such insurance contracts. Those whose right to these deductions was challenged with such suddenness last year by the Tax Department with the backing of two members of the Income Tax Appeal Board will undoubtedly breathe a sigh of relief.

As everyone now knows, the difficulty which gave the excuse for the amendment arose from the interpretation which the Tax Department placed on the word "reserves" in a clause in the Act which prohibited the deduction of "reserves" in computing business profits. The opposite view, that the word "reserve" did not bear the meaning contended for by the Tax Department, had, it is true, been confirmed on two occasions by the Exchequer Court of Canada, but when last year the Tax Department's interpretation finally received the support of the Income Tax Appeal Board restraint was thrown to the winds and the resulting outcry from all sections of the country was sufficiently heart-rending to induce the Department to acquiesce in an amendment to the law. An amendment which never would have been necessary had the Department been willing to accept the interpretation placed on the statute by the Exchequer Court which, after all, is a higher court than the Income Tax Appeal Board.

The amendment authorizes the deduction of certain provisions or allowances in respect of future obligations (goods, services, and containers) or future periods of time (rent, hire, and insurance commissions), and provides a convenient option for dealing with amounts due under long-term sales contracts, e.g. for houses. To a degree, therefore, it is in accordance with the accounting view on these matters. To a degree? Yes, because on the one hand certain provisions or allowances which ought to be made in ascertaining the profit of a year are expressly excepted from the amendment, e.g. for future obligations arising under guarantees, warranties and indemnities, or are not mentioned at all, for example, an obligation to make a refund on the return of merchandise which has been

sold, which suggests (though perhaps not conclusively) that no such allowances are contemplated. Moreover, the "reserves" which are expressly made deductible are described in language so excessively careful and surrounded by so many safeguards that one cannot help but wonder if the "reserves" which emerge from the taxation mill will bear much resemblance to the allowances known to the accounting profession. Certainly the name is different.

Recruitment Committee's Questionnaire

LAST year Mr. George C. McDonald, C.A., of Montreal, a past president of the C.I.C.A., visited the various provincial Institutes in his capacity as chairman of the committee on recruitment and training for professional accountancy. His object was to obtain the views of a cross-section of accountants on the problems of student recruitment, training, examinations and other related matters. The committee is now engaged in analyzing the information gathered by Mr. McDonald to determine what changes are necessary in our recruitment and training programs.

To provide further information for its guidance, the committee will issue a questionnaire later this month to all accounting students on the mailing list. It is hoped that all students will reply to the questionnaire which is designed to inform the committee of the attitude of accounting students towards various aspects of the training program and to the profession generally.

Complete anonymity will be maintained. Neither the student's signature nor identification of the firm for whom he works is required. The committee on recruitment and training would appreciate the wholehearted support of the profession in this important project and hopes that, when and if the matter is brought to their attention, members in practice will encourage their students to complete the questionnaire and return it to the committee.

ENQUIRIES RE STOCK HELD BY ONTARIO TRANSFER AGENTS

The Stock Transfer Section of the Trust Companies Association of Ontario has asked the C.I.C.A. to request its members, when making enquiries in connection with stock held by transfer agents, to furnish sufficient information to identify the entire transaction in question. Specifically, the following information is considered necessary:

Name of stock
Certificate number(s)
Receipt number(s)
Number of shares
Class of stock
Names of transferor and transferee.

The Stock Transfer Section also asks that copies of the information requested by auditors be furnished in duplicate so that one copy can be stamped "confirmed".

A minimum charge of $1.00 will be made by transfer agents for supplying information asked by auditors.

The Profession Of Accountancy

By Lorn McLean, C.A.
President of the C.I.C.A

The profession of accountancy includes public accountancy and administrative accountancy and they have common interests

THE position of president of The Canadian Institute of Chartered Accountants should, I think, permit one in the course of his travels across the country to encourage acceptance for any personal views he thinks are important, and of which acceptance is lacking or lagging. This brings me to my topic which is "the profession of accountancy". In discussing the profession, I shall deal with only two aspects of it: first, its true present boundaries and, secondly, some tendencies and evolutionary changes which are now at work in it.

In my travels I have discussed with some of my fellow members the position of those of us who are not engaged in public accounting. There are many who believe we have "left the profession" as the saying goes and there are some who believe we have extended the boundaries of the profession. In presenting my views on this subject, I prefer to start at the beginning and to try to argue this thing out to my own satisfaction, and I trust to yours.

Before starting, I wish to say something we all realize, which is that accountancy, in the manner in which it is practised, is constantly changing and evolving. It certainly has been changing very swiftly in the last 30 years or so, and this suggests to me that it is wise, from time to time, to reconsider our assumptions and take a fresh look at our definitions. This should not be too difficult for us; for we are people of education, and an educated person has been described as one who, amongst other things, can entertain himself, can entertain a friend, and can entertain a new idea.

The True Bounds of the Profession

Well, then, to start at the beginning, what characterizes any profession? I think that two things characterize a profession. The first is a strict and lengthy training and the second is a responsible attitude to society, or as sometimes briefly stated, technical competence and moral obligation. Looking at my own case and that of many scores in this country like me, I say that if to suggest we have "left the profession" means anything at all, it means one or both of two things: either we have lost the benefit of our training, that is, have lost our technical competence, or we have forsaken our sense of moral obligation, our sense of consideration for the public welfare. Either suggestion, of course, is complete nonsense. There-

An address delivered to meetings of chartered accountants in various cities in Canada

fore, the profession we are concerned with is not the profession of public accountancy; it is something larger, it is the profession of accountancy. In common with all professions it has the sense of moral obligation, and particular to itself it has technical competence in the field of accountancy, and all people in accounting who possess these qualities of technical competence and moral obligation are members of the accounting profession. Here then we have the profession of accountancy which at present is practised in a variety of ways. There is the public accountant, historically the senior. There is the accountant in the teaching post, and there is the accountant in the administrative post in commerce, industry, or governmental service. (And in order not to be accused of false pride and incomplete coverage, let me add that the profession in Canada is not confined to chartered accountants although they are its unquestioned leaders.)

Having defined what I conceive to be the true present boundaries of the profession of accountancy, I wish now to look inside those boundaries and single out the chartered accountants in Canada. I have mentioned three segments of the profession of accountancy and I shall now, speaking only of chartered accountants in Canada, compress them into two groups in order to discuss their numerical strength. The first group comprises the chartered accountants in public practice, and the second group comprises the chartered accountants in administrative posts, with which I couple those in teaching posts. The second category, which we call the administrative accountant, has risen from very small beginnings — say about 30 years ago — to very impressive proportions.

Public Practice and Administrative Practice

Before discussing numerical strength, however, I should say a word on terminology. The Canadian Institute of Chartered Accountants recently received a report it had requested from Mr. George McDonald of Montreal, one of the deans of the professions of accountancy in Canada. He was reporting on recruiting and training for professional accountancy, and his terminology was "the chartered accountant in public practice" on the one hand and "the chartered accountant in administrative practice" on the other. I like those terms; I commend them to you.

In 1935, which was the year Mr. McDonald chose for comparison, those in public practice were 69% of all chartered accountants in Canada, those in administrative practice 31%. In 1951 the 69% had dropped to 57% and the 31% in administrative practice had risen to 43%. Hence, of approximately 5400 chartered accountants in Canada, 3100 are in public practice and 2300 are in administrative practice.

Common Interests

I see no conflict whatever between the two groups of accountants, the public and the administrative; they are quite capable of being congenial members of the same profession. Take, for example, the question of training. In my estimation, our training suits us for both vocational choices, although once a vocational choice has been made, then obviously certain supplementary aspects will be emphasized. I think it is a good thing, moreover, that our vocational choice can be delayed until we are mature, since we have a better chance then of making a wise decision. I think also that other matters of prime concern are matters of common concern. To illustrate: I was in Houston, Texas, some months ago at the 1952 annual meeting of the American Institute of Accountants and I was quite faithful in attending the general sessions because I wanted to form my

Mr Lorn McLean, C.A., president of the C.I.C.A., was born in California and graduated in Modern History from the University of Toronto. He was articled to Price, Waterhouse & Co., Montreal, and in 1927 was admitted to the Quebec Institute. In 1940 he joined the B.C. Power Corporation of which he is now vice-president. He became a member of the B.C. Institute in 1944 and was its president in 1949.

opinion of the extent to which matters they thought sufficiently important to discuss in their annual meeting were matters of common concern to public accountants and administrative accountants. Amongst other things, they discussed selection of staff, they discussed training, and they discussed supervision, and obviously this whole field of personnel administration, which is the most critical and important field at the moment in any segment of business, is of as great concern to the administrative as to the public accountant. Another topic they discussed was fair disclosure in financial statements. Here again the topic is of prime concern to both groups.

I have now said something about the true present boundaries of the profession of accountancy. I have identified the two large constituent groups which compose it and I have stated my belief that there is no conflict in the primary interests of the two constituent groups. I would like to turn now for a moment to each of these two large segments of the profession in order to discuss certain tendencies I see at work in each of them respectively. Before I start I want to say that these tendencies may be less apparent to some firms and enterprises than to others, and may be less apparent in certain parts of the country than in others. However, I am sure that these tendencies are at work and growing, and if they have not become apparent in certain quarters they will in due course.

Tendencies in the Administrative Field

In the administrative field, I think that one thing of great importance is the extent to which accounting officials have professional qualifications and have staffs which are well trained both academically and on the job.

Another development in the administrative field is a growing recognition that, whereas in a business a certain matter may have a production aspect or a certain other a public relations aspect, a certain other a sales aspect, and so on, everything that a business does has a financial aspect and affects the accounting records. The latter is the pervasive function. Another way of stating this is to say that accountancy is the basic language of the world of business and is the only language in which something significant can be said about all business activities.

I shall now refer to a third development in the administrative field. A business, certainly a large business, to be operated effectively must have frequent accounting reports, monthly at least, and these periodic reports must be in harmony with the annual reports which the auditors, the public accountants, will in due course report upon. This is the most important tendency I have to mention in the administrative field, most important in the sense that in Canada much of its recognition is still before us. It would be unthinkable to conduct a large business through the twelve months of the year with monthly reports, on the strength of which irrevocable decisions are made on such matters as dividend disbursements and wage settlements, and then find after the year-end that the results they portrayed were significantly taken exception to by one's auditors.

There is also the growing practice on this continent of issuing quarterly financial statements in reliance upon which investors decide whether to hold, to buy, or to sell securities: such quarterly statements are rarely supported by the opinion of a public accountant. Therefore, the administrative accountant must take steps to see that his monthly and other interim reports are in harmony with the year-end accounts. That means the accounting staffs in our businesses must be trained to detect an accounting problem or a debatable point of material effect as soon as it arises, so that its treatment may be discussed and agreed upon with the company's auditor, with the result that the treatment which will stand up is reflected in the statements of the first month affected. These things having been done, the year's reported results are simply the summation of the results as shown month by month upon which the management has charted its course during the year.

It is chiefly for these three reasons, the professional qualifications of an increasing number of accounting officials in business, the recognition of the pervasive character of accounting, and the acceptance by accounting officials in large enterprises of the obligation to see to it that their periodic reports are in harmony with the year-end accounts which in due course will receive the blessing of the public accountants, that accounting officials are obtaining increasing status in the inner circles of top management.

Public Accounting Tendencies

Of tendencies in the field of public accounting, I find there is a logical development which recognizes the calibre of the people who are conducting the accounting for corporations and places reliance on the candid consultation during the year when matters of controversy arise. This cannot fail to have its effect on the public accountants' work: the reliability of the records he is examining obviously must have the result of less detailed work being performed and therefore less work existing for junior members of his staff. More and more the chief concern will be the scrutiny of internal controls: the devices and arrangements and allocations of duties by which the production of reliable accounts is safeguarded. I believe the public accountant's approach will be more philosophical and imaginative; less time will be spent in his examinations, but it will be time spent by people with higher qualifications. The discussion and settling of accounting problems throughout the year as they arise and the scrutiny of internal controls at a time of the auditor's choice both work to alleviate year-end peaks and to mitigate the miseries of the "busy season" which have historically been an unhappy aspect of the life of a public accountant.

In closing my remarks I would like to go back to what I said earlier, that in the two fields of public accountancy and administrative accountancy, the common training fits one equally well for either direction, the problems of the two fields which are of first importance are matters of common concern, and, furthermore, the tendencies at work in the respective fields of public accountancy and administrative accountancy make each an exciting and rewarding area of work to those for whom each field holds particular appeal.

Last In, First Out: The Businessman's Inventory Method

By Maurice E. Peloubet, C.P.A.

While the average businessman does not understand the complexities of accounting theory he has a very keen sense of the flow of cash

Not a New Method

IN the form in which the last-in, first-out inventory method is currently used it is not as old as some other methods, but it has a long and honourable, if slightly obscure, ancestry. Even so, the actual technique of last-in, first-out, as we apply it today, has been in use some 25 to 30 years at least. The history of the inventory valuation and costing methods which led to the adoption of LIFO goes back much further than that, certainly some 70 years and quite possibly earlier.

Changing Meaning of Inventories

One of the difficult things about dealing with inventory methods, from a historical point of view, is that the word has remained unchanged for over 500 years, whereas its significance has been changing all the time. Although there has been a continuous evolution we might say that the significance of inventories has gone through three major transformations.

When first used in the accounts of medieval merchants, such as the traders of Venice, Genoa, Florence, Pisa, and the cities of the Hanseatic League, and later in the accounts of the merchant adventurers of England, the word "inventory" generally meant a total summation of everything the merchant owned — cash, goods, ships, warehouses, and any other property. Current values, rather than costs, were the criterion and the merchant determined his income by finding out how much better off he was at the end of the year than at the beginning. The inventory, as understood at that time, was, in effect, a single-entry balance sheet. This method worked well enough when commerce was based principally on the results of individual transactions or voyages — in other words, a sort of "one-shot" method of doing business.

As communications improved and as the business of the traders increased and became more regular, the business based on a continuing series of similar transactions gradually came into being and we have the large and established traders' concept of inventory as opposed to that of the one-shot merchant adventurer. Here, the cost of the goods included in the inventory became important, and the inventorying and revaluation of fixed property dropped

An address to the Toronto Control of the Controllers Institute of America, March, 1953

out of use. Inventory became what Adam Smith calls the "general stock" of "circulating capital" consisting of "provisions, material, and finished work". This concept is closer to the modern idea of inventory, the subject matter is the same and the purposes of inventory taking are similar. Such traders' inventories accomplished one of the first purposes of a modern inventory, that is, marking a cut-off point and recording uncompleted transactions. As this was primarily a traders' concept the idea of cost, rather than value, began to assume importance.

Inventories and the Industrial Revolution

In the early days of the industrial revolution, as Adam Smith's masterly analysis of the nature of fixed and circulating assets indicates, this traders' concept of inventory was carried over bodily into manufacturing, which was then beginning to assume something of its later importance. For a long time manufacturers contented themselves with handling their inventories on a trading basis. Manufacturing organizations were not large, the amount of machinery compared with hand labour was small by modern standards and the manufacturing and converting processes were comparatively simple and did not generally require a long time in process.

Inventory Requirements of Large Scale Manufacturing

In the latter part of the nineteenth century modern manufacturing methods and the larger scale of operations began to require large inventories which were never liquidated so long as the enterprise was in active existence. The owner of a cotton mill observed that he had to keep, in what I believe in Lancashire was called the "threading account", enough cotton in the shape of yarn and thread to make it possible for him to put raw cotton in one end of the process and get finished cloth from the other end, all the time maintaining the cotton yarn and thread in his inventories and on the spindles, looms, and all the other machinery in the mill. In the same way the smelter and refiner, say of copper, in Swansea in South Wales found that he had an increasingly complex process to deal with as his metallurgical methods improved and he found that he was tying up more and more metal and more and more capital in his processing. The manufacturer of iron or steel in various forms found that the same thing was true for him. Manufacturers who used imported materials found that larger and more complex operations were forcing them to carry a larger and larger permanent stock of materials.

Profit Realization

The average businessman did not then, and does not now, understand the complexities and subtleties of accounting theory and practice. If he did he would be an accountant and not a businessman. But the average manufacturer has a very keen sense of the inflow and outflow of cash, and he is very sensitive to the realization, or lack of realization, of a so-called profit. The instincts of the average businessman on financial matters are generally sound although he often tries to follow those instincts by the application of rather crude methods.

The feeling that there was something wrong in revaluing a constant inventory at different prices every year, coupled with the fact that an income tax had been in effect in England continuously since 1842 and before that from the year 1799 to 1813, made the British manufacturer try to do something to correct the tendency of what

Mr Maurice E. Peloubet, C.P.A., is a past vice-president and treasurer of the American Institute of Accountants. A partner in the New York firm of Pogson, Peloubet & Co., he is a member of the New York, New Jersey, and Texas Societies of Certified Public Accountants. His articles appear frequently in *The Journal of Accountancy* and other publications.

he instinctively saw was the recognition and the taxation of an unrealized profit.

Base Stock Method

Several devices were employed to bring about the desired result, most of them crude and simple but effective. The continuous use of a base price for inventory and the use of an arbitrary fixed amount of inventory were two of the methods used to avoid fluctuations in inventory values. The most satisfactory, however, and the most widely used was the base stock method which assumed that a certain fixed stock of material would always be kept on hand and would always be valued at a fixed, low price. If this stock were reduced by sales then the merchant set up a reserve to replace, which reserve was reversed as and when replacement was made, at which time the material purchased for replacement would be written down to the fixed price of the fixed stock.

This method, even when consistently followed, is arbitrary and might lead to the creation of improper secret reserves. However, if the opening base stock were valued at cost at the time it was acquired and the base stock was not grossly in excess of what was needed, the method can be successfully operated and will show correct, realized profits for each year. The base stock method has undoubtedly been in use in England since the middle 80's of the last century. Its use was permitted for income tax purposes. There is not much official evidence of this as, so far as I know, there have been few cases or disputes about the application of the method. It was largely confined to the steel and iron, base metal, and textile trades with, I believe, a few members of the chemical industry included.

There never seems to have been any great movement to extend the use of the base stock method beyond the trades mentioned. Probably one reason for this is that the base stock method was developed in a period of relatively stable prices. The materials used in the industries where the base stock method was adopted were subject to more violent price fluctuations than the finished goods produced from them. The method was used principally to make certain that current costs were matched against current sales and that no profits were shown as a result of unrealized inventory appreciation.

Legal Position of Base Stock in England

There was, I believe, in the First World War, some question as to the applicability of the base stock method to excess profits tax income. I have been told of cases where the base stock method was allowed for ordinary income but not for excess profits. In any event, the base stock method originated and was fairly widely used in England and is the forerunner and prototype of the last-in, first-out method which has been developed from it. Actual legal precedents for the use of the base stock method in England will not, I think, be found principally because the issue has not, so far as I know, ever been clearly litigated, and the evidence of its use on a permissive

basis untested by Court action would be most difficult to obtain.

Early History of Inventory Methods in the United States

The history, however, of the base stock method in England is valuable to the student of LIFO principally because it establishes two things — first, there is nothing particularly new in the fundamental LIFO concept and, secondly, the base stock method was originated not as an accounting method but through economic pressures on businessmen seeking a method for the statement of income on a realistic, realized basis rather than on the basis of continued revaluation of an unrealized and unrealizable inventory.

In the United States manufacturers began to feel, early in this century, much the same uncertainty about the nature of the profits derived from revaluation of inventory as the English manufacturers felt. While they did not have the pressure of income taxation at that time, they still felt that it was dangerous and undesirable to overstate profits in a rising material market and that it was unwise to exhibit to stockholders profits which could not be realized and could not be paid out in dividends.

Two examples of companies using the base stock method were the American Smelting and Refining Company, which first used the method in 1906, and the National Lead Company, which used the method in 1913. There were a number of important industries which adopted the base stock or last-in, first-out method long before it was allowed for tax purposes, principally because of the disinclination of management to show profits which certainly were not realized and which, in the opinion of management, had not actually been earned.

There is no great point in trying to remember specific items in this historical background as few, if any, of them taken by themselves are of great significance. What is significant is the continued trend towards a costing and inventory valuation method which would eliminate unrealized profits and produce an income account based on current costs applied to current sales.

The use of measures to bring this about was the result of economic pressures and the feelings and actions of businessmen rather than the adoption of any ingenious device developed on a theoretical basis by accountants. The accountants' part in this was largely that of a systematizer, an adaptor, and a formulator, rather than an originator. This is as it should be. It is merely one more example of what George O. May, in his book on "Financial Accounting", describes as the "utilitarian basis for accounts". In other words, accounting must be useful to business, government, and the general public, and it must follow the purposes and actions of businessmen rather than attempt to set up standards of its own different from, and possibly in conflict with, business practice.

Effect of Kansas City Structural Steel Co. Decision

Until the year 1930 it was generally thought in the United States that the use of the base stock method would gradually extend to most of the industries to which it was well adapted and that it would be recognized in the same way as other inventory methods had been recognized as a suitable method for the determination of taxable income if consistently applied. There were many capable tax lawyers and accountants who believed that the Commissioner of Internal Revenue had ample authority to permit the use of the base stock method. Also, it was thought that this could be brought

about by a mere expansion of the regulations in somewhat the same way as the use of the lower of cost or market for first-in, first-out inventories and the use of the retail method for retail merchants had been permitted. The Commissioner of Internal Revenue thought otherwise in the case of the Kansas City Structural Steel Company and a Supreme Court decision stated that the base stock method did not clearly reflect income and was not a permissible method for calculating taxable income. The case was an unfortunate one as the Kansas City Structural Steel Company was not a manufacturer but was in the business of trading in structural steel. It was, however, necessary for the company to keep a basic stock to meet the demands made upon it and the case might, with more intensive preparation, have been presented to the Supreme Court in such a way that the beneficial economic effects of the use of the base stock method would have been more clearly apparent. In any event, the case was lost.

LIFO Answered Objections Raised in Kansas City Structural Steel

A few years before the *Kansas City Structural Steel Company* case the LIFO method had been worked out as a somewhat more precise and controllable variant of the base stock method. The LIFO method successfully overcame most of the objections brought forward by Justice Brandeis in the *Kansas City Structural Steel* case against the base stock method. For the following ten years those interested in the use of LIFO for corporate and tax purposes did what they could to educate the business public, the accounting profession, and the members of the Senate and the House of Representatives responsible for the revenue legislation in the purposes and the effects of LIFO.

LIFO Recognized For Federal Tax Purposes

These efforts culminated in the passage of LIFO legislation in 1939 under which the statute stated that any taxpayer could adopt the LIFO method merely by making application for the right to use it and presenting certain specified information with his income tax return for the first year for which he wished to use this method. One peculiarity of the statute was the requirement that all financial statements to the public or to third parties issued after the adoption of LIFO for tax purposes had to be on a LIFO basis for corporate purposes. This was not a hardship but the provision was presumably inserted in the statute because of representations made to the Treasury Department that LIFO was not a *bona fide* accounting method but was a mere device to reduce or defer taxes. The proponents of the use of LIFO, while they did not feel that this provision was necessary, did not oppose it. It now appears that the provision was a wise one as it seems to have convinced members of Congress and government officials of the fact that those using LIFO do so for the most part primarily because it shows a truthful and accurate income rather than because its use results in the deferment of tax payments.

LIFO Is Not Primarily A Tax Device

On this point it is interesting to observe that the United States Department of Commerce, in its calculation of total corporate income in the United States, makes an adjustment designed to place the total corporate income of the country on a LIFO basis because, in the opinion of the Department of

Commerce, that basis more clearly reflects the true national corporate income.

Another piece of evidence that LIFO is not entirely or predominately a tax device is offered by the published accounts of the Caterpillar Tractor Company which used LIFO in its corporate accounts several years before it went on that basis for tax purposes. While we should not attempt to draw too many inferences from published accounts, the accounts of the American Woollen Company, which does not use the LIFO method of inventory, show for many years past very large fluctuations in net profits. Other textile companies on the LIFO basis show much smaller fluctuations and the fluctuations shown by the companies on the LIFO basis more nearly correspond with the changes in the cash position. These comparisons are offered merely as showing the different effects of the two inventory methods.

Actual Operation of LIFO

We have devoted some time to the historical background of the LIFO method, which is quite important to a proper understanding of it. The actual operation of the method can be in some cases quite simple and in others it must, from the very nature of the enterprise, be quite complex. The simplest application would be in an industry using one type of material which goes through the fabricating process without chemical alteration and where the material which does not enter into the finished product is recovered as scrap and furthermore where the scrap has the value of the original raw material less a conversion charge. Such a condition is found in a mill producing copper, brass or aluminum products, such as sheets, bars, rods, and tubes. Here the metallic content of the inventory is known at all times and the total of the contained metal can be ascertained and valued at the close of any period. Furthermore, the contained metals all have currently quoted market prices. If such an enterprise had, say, 5,000,000 pounds of copper and 1,000,000 pounds of zinc in the beginning and end of year, it would be very simple to value at the end of the year that much metal at the prices in effect at the beginning of the year. Labour and overhead contained in the inventory could be adjusted on a basis of rates and prices in effect at the beginning and the end of the year.

As we get into products which change their nature chemically and which are combined with others, we run into more difficult problems. In some cases it is best to handle the inventory on a departmental basis and in others the so-called dollar-value method may be preferable.

Development of the Investment Concept of LIFO Inventories

While there has been no change in the basic principles of LIFO since the passage of the 1939 legislation, there has been much development and, I think, improvement in its operation and administration. The early proponents of LIFO were well aware of the basic fact that it is the investment in the inventory rather than the physical units which remains fixed or constant to the extent that such an inventory is necessary for the operation of the enterprise. In writings on this subject of 25 or 30 years ago references are frequently made to the analogy between a minimum operating inventory and a fixed asset of the type represented by buildings, machinery, and equipment. However, the full implications of this concept of the fixed minimum inventory as a permanent asset or investment were not realized in any practical sense. There was a tendency

among the earlier proponents of LIFO to operate the method in somewhat narrow categories and to pay far too much attention to physical factors which had little or nothing to do with the investment situation.

It was assumed by the Bureau of Internal Revenue, of course erroneously, that the only method of operating LIFO was on the basis of the sale and replacement of closely similar items. The idea, for instance, that rayon or nylon could be substituted for cotton or wool in a LIFO inventory, or that an excess of unfabricated metals could be counterbalanced by an increase in the metallic content of fabricated goods, were ideas which were not even considered in the practical application of LIFO at the time of the passage of the 1939 statute, although they were implicitly contained in the general LIFO concept. The thinking, both of businessmen and their advisors and the United States Treasury Department, has gradually developed in the direction of a broader application of LIFO, particularly in procedures which have as their ultimate, though generally unexpressed, goal the recognition of the investment basis for LIFO rather than the basis of substantial identity of goods.

One of the first steps in this direction was the promulgation of Treasury Decision 5407. This was the result of a number of conferences between officials of the Bureau of Internal Revenue and representatives of taxpayers. The taxpayers were principally those engaged in the meat packing, textile, leather, and nonferrous metal fabricating industries. These industries have certain common characteristics: their products, while complex in themselves, are produced from a comparatively small number of basic raw materials; the value of the basic raw material in the finished product is a large part of the cost; the basic raw materials are subject to wide and rapid price fluctuations; and the raw material content and process losses can be ascertained at the end of each principal manufacturing operation.

In these industries it was the custom to carry in the accounts inventories on the basis of the raw material content of the different sections of the inventory — raw, in-process and finished — and the charges for labour and overhead incurred in the operations up to the stage which the raw material had reached. The inventory would not, say, for a brass mill, consist of so many bars or billets of raw copper or zinc, so much scrap metal, so much semi-finished sheets, bars, rods, and tubes, and so much finished products, but would rather consist of a total amount of copper, zinc, lead, nickel, and other alloy metals contained in the inventories and an accumulated amount of fabricating costs derived from departmental records. Similar methods are, and have been, in effect in other industries.

There was some doubt in the minds of the Bureau officials about the propriety of considering the raw material content of the inventory in total. Some officials thought that the statute was to be construed as narrowly limiting the application of LIFO to specific and comparable articles. For instance, while all individual sizes of brass sheets should not be required to be inventoried separately it was thought that, perhaps, pounds of sheet brass was a proper category. After considerable discussion and after a careful explanation of actual operating methods, the officials of the Bureau decided that it was proper to permit raw material to be carried as such, however it might be physically included in the inventory. This was one of the first and one of the longest steps away from the idea

of following LIFO through item by item and towards substituting for such a method the ascertainment of the investment in raw materials and fabricating costs.

While statistics of taxable income and revenue on an "as if" basis are difficult, if not impossible, to arrive at, it seems quite likely that the principal gain, both to the taxpayer and to the Bureau of Internal Revenue, through the adoption of Treasury Decision 5407 and the regulations subsequently passed upon it, was more ease and certainty of administration. Taxable income may have been reduced in some years and may have been increased in others but I am inclined to think that the long-run effect on taxable income was negligible. On the other hand, I have no doubt about the benefits of the simplified accounting and tax calculations which it made possible and of the possibility of preparing tax returns which were not at variance with financial and operating accounts.

For a long time, indeed from shortly after the passage of the 1939 legislation, several groups of taxpayers, who could not possibly adopt LIFO on an item for item basis, felt that they were discriminated against because they were just as concerned as other taxpayers with matching current costs and current sales and with the avoidance of fictitious profits or losses shown by reason of writing-up or writing-down fixed investment in inventory.

Department stores and retail merchants made up the largest group of such taxpayers. They were concerned with the application of LIFO to inventories containing a large number of different items where the general nature of the items remained the same but where the individual items were often not specifically replaced. Some wholesale dealers were also concerned with this problem. Here. of course, we have the ultimate development of the investment theory of LIFO and the complete abandonment of the identity of material concept.

Litigation Leading To The Use Of The Dollar-value Method

The taxpayers did not have as easy a time in bringing the Bureau of Internal Revenue or the Treasury Department around to their view on this method as they did in getting the permission of the Bureau to use the raw material content of inventories under Treasury Decision 5407. In fact, the Bureau of Internal Revenue and the Treasury Department stated frequently to many taxpayers that the dollar-value method of determining LIFO inventories would not be accepted for purposes of determining taxable income. There were some taxpayers, however, who had the determination, the means, and a large enough amount of tax at stake to warrant litigation beyond hearings before the Bureau of Internal Revenue. One taxpayer, Hutzler Bros., a large and important department store in Baltimore, Md., carried its case to the Tax Court. The case was decided on January 14, 1947 in favour of Hutzler Bros. and the Bureau of Internal Revenue was, in effect, directed by the Tax Court to permit inventories in the various departments of a department store to be valued by the application of suitable index numbers to the investment in each department. The purpose was to maintain the original investment in the inventory at the time the LIFO method was adopted at the price level of that date, and to maintain so much of the inventory as was purchased at higher price levels and still remained in stock at those levels. The Bureau of Internal Revenue, in its regulations issued under the *Hutzler Bros.* case, has required the use of certain index numbers, prepared by govern-

ment departments. The preparation of these, it is interesting to note, was paid for by the department stores intending to use them. These index numbers are applied to the inventories of the different departments.

In the case of Edgar A. Basse & Company, a wholesale grocer, decided in the Tax Court on February 19, 1948, the taxpayer was permitted, in effect, to devise his own index numbers from quoted or invoice prices of materials weighted by the quantities in his inventory. This method is, of course, much more flexible and much less cumbersome than the method prescribed for department stores and retail merchants. It is easily applicable to manufacturing operations, and many taxpayers have changed to the LIFO basis since the decision in the *Basse* case.

Wide Adaptability Of The Dollar-Value Method

This method is adaptable to the situations of many types of manufacturing companies. Where the manufacturer produces one product or one type of product only, for example tool steel, machine tools, electric batteries or motors, of which all the items are essentially the same, the manufacturer may treat his entire plant as though it were one department of a large enterprise and he may develop one index number for his material, one for his labour, and one for his overhead. In a more complex operation it would be necessary to departmentalize the inventory and treat each department separately. This method has been applied successfully to several manufacturing enterprises and will undoubtedly have an increasingly wide use.

One of the great advantages of the dollar-value method is its flexibility and the fact that the substitution of one material for another carries with it no penalty. For example, I understand that substantial amounts of specially treated nylon are being mingled with wool in the production of floor coverings. Under the identity of material concept, or even on the basis of Treasury Decision 5407, a manufacturer who formerly used nothing but wool and now operates on half wool and half nylon would have shown a substantial profit on the liquidation of part of his wool inventory on which he would have been taxed and would have been forced to include his newly acquired nylon inventory at its present high price. On a dollar-value method no such difficulty would arise as the investment in the inventory at the beginning of the year at beginning-of-the-year prices would still be carried forward in the same amount at the end regardless of whether the investment was in wool or in wool and nylon mixed. This treatment of substitutions is one of the most important characteristics of the dollar-value method and one of the most important protections which the taxpayer has against being forced to write up his inventory even though on LIFO.

An Example Of A Dollar-value Inventory

The dollar-value method is quite simple in principle but, I must admit, generally complex in application. Almost from the time the original LIFO legislation was passed attempts have been made to value inventory on the basis of continuity of investment rather than of continuity of material. It was argued that a department store must have in its shoe department, for instance, about the same investment in shoes at the end of a period as it had at the beginning if the store were to operate continuously. It was agreed that the items in such a department would change in response to the de-

mands of style, fashion, and greater demand for shoes for one purpose than for another. But it was argued that the number of customers who will buy shoes from the department will be about the same. The turn-over will be about the same. Therefore, it will take about the same investment to operate the department.

In order to put such a theory into effect the department stores first endeavoured to develop indexes of their own on the basis of which the investment at the end of a period could be converted into the investment at the beginning of the period. Later they used the indexes compiled by government agencies.

For example, if the index number for shoes in a department showed that during the year prices had advanced on the average 25%, and if the inventory in the department at the beginning of the year had been $10,000 and at the end of the year it stood at $15,000, then $12,500 of the closing inventory would be valued at $10,000 and $2,500 would be considered as an addition to the inventory during the year.

If anyone is particularly interested in dollar-value applications I recommend a book called "The Retail Inventory Method and Lifo", by Malcolm P. McNair and Anita C. Hersum, published by the McGraw Hill Book Company. This contains some of the most informing explanations and illustrations of the dollar-value method that I know of.

LIFO Reflects Business Practice

Stripped of all its technicalities, which I agree are often difficult and confusing, LIFO merely attempts to reflect in the financial accounts the way most businessmen actually run their businesses. The average manufacturer, if he is asked to make a bid or an estimate on a contract for a new product, does not say to himself, "We have an inventory of so much material purchased one or two years ago at a different price from that which now prevails. I will, therefore, make a quotation based on consumption of material at that price. My accountant tells me that is the amount which will go into cost, under our first-in, first-out inventory method, against that order so I must use it for estimating." If a businessman made his calculations that way one of two things would happen. If the current price of material were lower than the price he had used for the bid he would bid on the basis of the older, higher price and would not get the order. If the current price of raw material were higher than his inventory price and he bid on the basis of the lower inventory price he would, in all probability, get the order and if he got enough such orders he would become seriously embarrassed financially.

No businessman, of course, operates in this manner. He makes his estimate on the basis of current raw material prices and current wage rates. He thus places himself in a reasonable competitive position and has a fair chance to get the business. If he gets the business he should, and probably would, make some arrangement to cover himself for the material, either buying it immediately or making some commitment or contract for its future delivery. In any event, it is the current price and the future delivery of the material on which he bases his bid. It might happen that the customer wants to get the product as soon as possible and it might also happen that deliveries of that particular type of raw material were rather slow. In that case, the manufacturer would begin to put the order in process immediately and would use up his low-priced inventory

in filling the order. He might have the whole order fabricated and shipped before he received the material which he bought to cover the raw material requirements of the order.

Under FIFO accounting the manufacturer would show, besides his operating profit, a profit or loss on raw materials and this profit or loss would be measured by the difference between the cost of the material which he purchased for this contract and the inventory price of the material which he substituted for his delayed delivery.

I cannot persuade myself that accounts on this basis are in any way correct or have any reference to business operations. From a business and operating point of view the manufacturer substituted his older low-priced material for the newer high-priced material which was delivered later, Financially he did exactly what he intended to. He obtained control of material for the order, he manufactured the order on the basis of his estimated fabrication cost and he would show a profit on his fabrication cost only if he considered the cost of the material he had purchased to cover the order as the cost of that order.

In general, I am sure that businessmen work this way. They do not think of themselves as selling off old inventory and replacing it. They think of themselves as producing for a current market at current costs and selling in that market. While administrative difficulties exist in the use of LIFO, it produces, where conditions require it, accounts and costs which are so much more useful and so much closer to being accurate that there is little reason for using other methods.

Where LIFO Is Not Applicable

If there are any cases where inventory prices, rather than current prices, are actually used as a basis for business transactions, then it is possible that FIFO or some other inventory method should be used. There are certain types of businesses to which LIFO is obviously unsuited. Any business in which specific articles are bought and sold, where a transaction really stands by itself, would not be adapted to the use of LIFO. A dealer in valuable antiques, musical instruments, some types of furniture, expensive jewellery, rare books or works of art might find that the application of LIFO to his business was impossible or impractical. There may be a few other types of enterprise to which LIFO is not applicable but we might say, in general, that any business which requires the maintenance of a substantial investment in inventory is probably a good subject for the use of LIFO.

LIFO Matches Current Costs With Current Sales

If we just remember that the purpose of LIFO is to match current costs against current sales we have the basic test of whether it is necessary or worthwhile to use the method. If you want to match current costs against current sales use LIFO. If this is a matter of no importance some other inventory method may be better.

Le Contrôle Interne et le Vérificateur

Par Robert Beaudoin, C.A.

On reconnaît deux méthodes d'analyser le contrôle interne d'une entreprise

DE nos jours le vérificateur fait de moins en moins de vérification détaillée, car même dans une petite entreprise le volume des opérations est souvent si grand, que le coût d'une vérification complète serait exorbitant et hors de comparaison avec le service rendu. Ne faisant qu'une vérification partielle, le vérificateur doit faire exercice de plus de prudence et de jugement s'il ne veut pas s'exposer à être responsable de négligence en n'ayant pas pris toutes les précautions nécessaires pour découvrir la fraude et les erreurs dans les livres.

Une Etude Approfondie

Pour bien déterminer les procédés de vérification et la quantité de sondage nécessaire, il est essential de faire une étude approfondie des méthodes de comptabilité du client et de la proportion de contrôle interne en existence dans son entreprise. Le contrôle interne ayant pour effet de prévenir ou diminuer les possibilités de fraude ou d'erreur; il est très important d'en faire l'analyse, c'est-à-dire d'en connaître les points faibles ou les absences complètes pour bien organiser son programme de vérification.

Ce travail d'analyse doit être confié à un comptable de rang sénior au moins, car un assistant n'aurait probablement pas l'expérience et les connaissances nécessaires pour découvrir les manques de contrôle et n'aurait pas un jugement assez avancé pour déterminer la quantité et la sorte de sondages nécessaires. Il est bon de posséder dans nos dossiers un document attestant que cette analyse a été faite, pour appuyer notre programme de vérification et aussi pour prouver les recommandations faites aux clients sur les améliorations possibles du système de comptabilité.

On reconnaît deux méthodes d'analyser le contrôle interne d'une entreprise:

a) La méthode narrative

b) La méthode du questionnaire.

La méthode narrative consiste à décrire brièvement les procédés employés pour inscrire chacune des transactions commerciales en notant tous les manques de contrôle. On l'accompagne ordinairement de copies des formules employées et d'un tableau synoptique du plan d'organisation de l'entreprise.

Cette méthode a le grand avantage de former au dossier une analyse complète du système comptable du client qui sera de grande utilité chaque fois qu'on voudra initier du nouveau personnel sur une telle vérification.

M. Robert Beaudoin, C.A., a commencé son stage chez Armand & Fillion, C.A. en 1946. Diplomé de l'Ecole des Hautes Etudes Commerciales en mai 1950, il a réussi l'examen final de l'Institut en octobre de la même anné. Il travaille chez P. S. Ross & Sons C.A. depuis janvier 1949.

Cependant elle doit être employé avec précaution si nous voulons nous en servir pour faire l'analyse du contrôle interne car en faisant la description nous serons plutôt portés à décrire les procédés employés sans chercher à savoir si l'on procède de la bonne manière. Le vérificateur qui fait l'analyse de cette façon doit être alerte pour découvrir les mauvaises manières de procéder.

De plus la description des pratiques comptables ne doivent pas être acceptés tel qu'expliquée par le client mais elles doivent être vérifiées par des sondages pour obtenir l'assurance que le système établit est actuellement en opération.

On reproche à la méthode narrative les points suivants:

(1) Beaucoup de temps est nécessité pour écrire en détail la description des méthodes comptables.

(2) Une telle description doit être revisée de temps en temps pour y inscrire les changements faits dans l'entreprise.

(3) Cela demande une grande expérience au vérificateur qui fait l'analyse pour déceler tous les manques de contrôle interne. Il ne possède aucun moyen de comparaison et il doit se fier sur ses propres connaissances.

La méthode du questionnaire consiste en une série de questions sur chacune des opérations comptables, destinée à découvrir les manques de contrôle dans l'entreprise. Les questions sont ordinairement bâties de manière à donner une réponse négative s'il y a défaut; de façon à attirer l'attention de l'examinateur.

Des exemples de questionnaires sont publiés par plusiers auteurs, notamment par R. H. Montgomery dans son livre "Auditing" ou il publie des questionnaires pour différentes entreprises, tels que commerciales et industrielles, des compagnies d'utilité publique, des banques, des compagnies de fiducie et des compagnies de placements.

De tels questionnaires ne doivent pas remplacer l'initiatives personnelles et ils doivent souvent être adaptés aux besoins de chaque client. Il arrivera que des questions ne peuvent être répondues par un oui ou un non catégorique, il est alors nécessaire de donner des explications détaillées.

Les avantages du questionnaires sont que:

(1) Les questionnaires étant préparés par des personnes d'expérience et versés dans les problèmes du contrôle interne ils constituent un moyen de comparaison pour mesurer les performances du système à analyser.

(2) Il donne au vérificateur l'assurance que des points importants ne seront pas oublier.

(3) It fait ressortir les points qui doivent attirer l'attention de l'examinateur.

(4) Il est plus pratique de travailler avec une formule standard qui guide et simplifie le travail.

D'un autre côté ses défauts sonts:—

(1) Il ne constitue pas une analyse historique des procédés employés.

(2) Il a tendance à éliminer l'initiative personnelle en indiquant le minimum de travail à faire.

En formant son jugement du contrôle interne le vérificateur doit tenir compte du fait qu'un système de contrôle peut être affaibli ou détruit par le travail des employés incompétants ou mal instruits des procédures à suivres. Les effets de changements dans le personnel ou dans la distribution des fonctions soit temporaires ou permanents doivent être aussi analysés pour corriger s'il y a lieu le programme de vérification.

Les points faibles dans le contrôle

interne doivent être rapporter par écrit au client avec les suggestions appropriées et les moyens d'améliorer le système de contrôle interne. Toutes autres suggestions pour améliorer ou simplifier le système de comptabilité doivent être étudiées pour savoir si elles n'affectent pas le contrôle interne.

Peu importe la méthode employée, il est important de faire l'analyse du contrôle interne, car c'est une protection pour le vérificateur, il s'assure ainsi qu'il a couvert tous les risques de fraude ou d'erreurs et il peut rendre de grand service à son client en lui indiquant les manques de contrôle dans son entreprise.

A Letter from a Reader

Kingston, Ontario
April 7, 1953

Sir: The general excellence of Bulletin No. 9 of the Committee on Accounting and Auditing Research which you published in the March issue of *The Canadian Chartered Accountant* is such that one hesitates to raise small points in criticism. Nevertheless that bulletin does make one minor recommendation with which I, for one, do not agree. It states, *"In the profit and loss account* charges in respect of certain of the above items may be described as, (i) Allowance for doubtful accounts . . ." (italics mine). But the same bulletin has recommended that the amount of the deduction from accounts receivable *on the balance sheet* be described as "Allowance for doubtful accounts".

It seems to me that the bulletin is recommending the same account title for two separate and distinct ledger accounts. This, in itself is not a matter of much importance, assuming the bookkeeper understands what he is doing. But what about the interpretation of the financial statements? A person unfamiliar with such accounting usage may be confused to find "Allowance for doubtful accounts" on the balance sheet at one figure and "Allowance for doubtful accounts" in the income statement at another figure. Just for what my opinion is worth, I think it would be better instead to describe the item in the income statement as "Bad debts expense".

J. E. SMYTH, C.A.,
Queen's University

MR. ABBOTT ON RETIREMENT PENSION PLANS FOR THE SELF-EMPLOYED

The Finance minister requests a critical analysis of his statement

HOUSE OF COMMONS, OTTAWA,
APRIL 10, 1953

Mr. Abbott: . . . During the past year I have received, as my hon. friend has said, quite a number of requests from professional groups urging amendments to the Income Tax Act which would allow a deduction for income tax purposes similar to that now provided for employee contributions to approved pension plans. In effect, the substance of these requests is for tax postponement on savings devoted to the purchase of retirement annuities. This request, although supported by a wider group this year than ever before, is of course by no means new. It has been put forward each year, I think, over a considerable number of years and, as I say, a great deal of attention has been given to it both by myself and by officials of my department. But I have not yet been satisfied that I should recommend to the house this new departure in principle under the Income Tax Act. As I said at the outset, I welcome this opportunity to give the house some of the reasons for the position I have taken on the matter.

First of all I should like to explain how it comes about that employees are given a deduction for their contributions to approved pension plans. Some solution had to be found to the purely technical problem of preventing double tax on pension income. All would agree, I think, with the general rule that income should not be taxed both when it goes into the fund and again when it is paid out. A decision had to be made as to when such income should be taxed. As the committee will recall, following the Ives commission report some years ago, we adopted the uniform system of taxing pension income when it is received as a pension out of the fund and freeing from tax, up to certain defined limits, income paid into the fund.

Personally I think that was a wise decision, for the alternative would have meant taxing income when paid into the fund, that is, taxing the employee in a year on income which in fact he never received in that year, the employer having deducted the proper amount from his wage or salary and paid it directly into the pension fund. Likewise, the employee does not receive currently that which the employer contributes on his behalf into the fund. It would have been a still greater anomaly to have required the employee to include in his income for tax purposes this additional amount placed to his credit by the employer in the year in which he actually earned this benefit. These are problems which were avoided by the principle of taxing only at the time the employee received his pension.

It is seen, therefore, that tax postponement for employees was introduced to solve the technical problem of removing double taxation and to avoid taxing employees on benefits earned in a year but in respect of which no cash equivalent was received in

the year. I might now point out that neither of these problems exists in the case of the professional groups which have asked for tax postponement on savings; that is, their income is not now taxed twice and they are not taxed on income not actually received or receivable in the year. Accordingly, tax postponement granted to them would be a purely gratuitous measure of tax abatement not justified by the necessity of meeting technical problems in the taxing statute.

I think it is fair to say that, although the government is interested in seeing pension plans adopted in industry, the tax postponement feature did not arise out of a policy designed specifically to give positive benefits to taxpayers. Rather it was adopted to remove existing tax obstacles to the reasonable operation of pension plans. In view of these facts it is not very effective, it seems to me, to attempt to argue by analogy that, because employees have tax postponement as a solution to their particular problem, therefore self-employed persons should likewise have it in respect of their voluntary savings.

Much of the discussion of this subject alleges that the existing provisions discriminate unfairly against the self-employed who cannot participate in a pension plan. It might be suggested, I think, that this difference in the relative positions of the two groups can very easily be exaggerated. Some aspects are frequently overlooked. For example, those who devote their savings towards the purchase of endowment policies or annuities receive very reasonable tax treatment in that they are never taxed at all on the interest earned by the funds paid in right up to the date of maturity of the endowment or annuity contract. The employee in a pension plan, however, pays tax on all the interest earned on his payments into the fund right from the day of his first instalment payment. This, I suggest, is an extremely important difference in the two situations, and is one that is rarely recognized by those arguing for the benefits of pension plan legislation. Furthermore, in the case of the employee who put his savings into a pension plan, those savings are completely locked up and are not available to him in the ordinary course of events. The self-saver, on the other hand, always has his assets in a form available to him for emergency or for convenience. There is, of course, no double taxation of funds used by the self-saver to purchase an endowment or annuity because the proceeds of their savings at maturity are tax free whether taken in a lump sum or in the form of an annuity. I suggest that an objective comparison of the relative positions of the two groups raises some question about accepting too readily the view that the self-employed are discriminated against.

Most of the requests which I have received for amendments to allow tax postponement on savings have come from well organized professional groups with national organizations. It seems clear, however, that once the law departed from its present principle of confining tax postponement to employees there would be no logical stopping point short of allowing this privilege to everybody, not merely to the self-employed but also to all employees who are not now covered by pension plans. The fact that certain groups have professional status with well recognized national organizations could not, I think, be regarded as a proper criterion for securing particular benefits under tax legislation. It is, therefore, on this basis of general applicability that I have had to consider this question of allowing tax postponement for savings.

The implications of such a move are extremely far-reaching. It is difficult to know what volume of savings would be attracted by this immediate monetary incentive, but I am inclined to think it would be extremely substantial. Most people, I think, would feel that they could not readily forego immediate dollar savings of quite substantial proportions in their annual income tax bill if the proposal were adopted. It should be remembered that the funds devoted towards the purchase of retirement annuities would not necessarily have to come out of additional savings, as is the case where employees have contributions deducted from current wages and salaries. In the case of the self-employed person, who generally will have some other capital assets, he could secure the tax saving by merely changing the form of his assets. He could, for example, sell stocks and use the proceeds as an instalment payment on a retirement an-

nuity. Again, it is not easy to estimate to what extent there would be a transformation in the form of capital assets now held by the ordinary citizen. However, whatever the volume of this switching of assets, it would be significant, I think, that under our tax structure monetary incentives would be offered for Canadians to invest their savings in a direction where the persons utilizing them would invest them almost entirely in debt or fixed interest bearing securities. I am not sure that at this stage of Canada's development I would like to take the responsibility for directing the savings of the Canadian people away from equities into debt securities. To me this would be an ill-advised policy on a country where there is such an enormous demand for risk capital for the development of our country and where the opportunities for participating in the growth and development of our country are so important.

Now, Mr. Chairman, these are some of the reasons which have caused me to hesitate about accepting the representations which have been made to me on this question. As my hon. friend from Eglinton has pointed out, I do not regard myself as in a position to be dogmatic about the matter, but I do feel that the implications of allowing tax postponement which encourages savings in special directions are such as to warrant the most careful study. As I said at the outset of this statement, I have not felt that I wanted to take the responsibility for such a far-reaching move at this time.

* * *

Mr. Fleming: In the first place, the minister has sought to distinguish the position of the employee because whatever is paid into the pension fund as his contribution does not come into his own hands in the form of income. I think that is not an accurate statement. It may well be that the money does not come into the hands of the employee and flow through those hands into the fund, but by arrangement with the employer the employee's pension contributions go directly from the employer into the pension fund. Surely that distinction is a matter of form only and not a matter of substance. There is no essential distinction in that regard between the case of an employee's contribution to a pension fund and that of a self-employed person.

* * *

But the employee of an employer finds himself in a favoured position, notwithstanding what the minister had to say—which I think is a matter of form and by no means a matter of substance—because the contribution does not go into the hands of employees but goes direct from the employer into the pension fund. That is no basis of distinction in principle at all.

Mr. Abbott: My hon. friend wants to be fair. My real basis of distinction is why should one form of saving be singled out for tax postponement. That is the fundamental consideration.

* * *

Mr. Fleming: . . . I do not wish to use the word "discriminatory" as applied to the present legislation. It is a very limited form of recognition of a principle that I think the government ought to encourage, namely the provision by people for their needs in the case of retirement. It is a very sound form of security that uses fiscal methods that are open to the minister in the form of the income tax to encourage people to provide for their old age, the days when after retirement they cease to be earning an income for their own support.

Here is a method at hand, it seems to me, not on the basis of discrimination but on the basis of the extension of a provision that has been recognized today and is fully established within the scope of the Income Tax Act. So far as I know, nobody has questioned the principle involved in section 11(f) and (g). It has never been questioned. It is accepted by everybody. It is fully established. If that principle is sound—and I think every member of this committee would say it is sound—I think there is no adequate answer to the plea that that sound principle now ought to be more widely extended.

* * *

Mr. Abbott: May I just add a word here. I made my statement today in the hope that it would be subjected to close critical analysis not only by members of the House of Commons but by members of the legal and accounting professions and those who are

as interested in this question as I am. I hope that it will be given that kind of analysis.

* * *

Mr. Macdonnell (Greenwood): . . . The one point I wish to make is as to the reality of the problem. With the steeply graduated income tax we all know how difficult it is, even for people with substantial incomes, to save. When the minister spoke about the position of the class that we are talking about now, and mentioned their shares, their bonds and the difficulty of administration because of the changing about of those, may I say that after all that applies to only a small fraction of those we are talking about. We are really talking about people who, as things stand now, find it extremely difficult, as the hon. member for Eglinton has said, to provide for their security, but who would like to do it notwithstanding the fact that the difficulties are great. I take it from the minister that he is pursuing the inquiry and that it is going to be earnestly pursued.

Mr. Abbott: . . . As my hon. friend knows they have a similar problem in the United States, because their system is somewhat similar, and they have not been able to solve it either. I have asked myself, if we are going to do that, why we should not allow the deduction of premiums on endowment policies and some of these other things. The thing is filled with complexity. I can assure the committee that it is far from one of those simple open and shut cases.

* * *

Mr. Fulton: As to one of the other difficulties raised by the minister himself, namely that to make this extension would perhaps open up very wide fields of conversion of savings into interest-bearing securities, rather than into equity capital, I would ask the minister whether he does not think a practical solution and one not causing very great difficulty would be found by placing the same limitation on the amount that might be paid into self-employed persons' pension funds as I understand is now placed on the amount of employees' earnings; that is, a ceiling on the amount that may be paid into the pension fund and thus on which the tax is postponed. Surely the difficulty, seen by the minister and stated there, would be very real if there were no limitation on the ceiling, so that all savings might eventually be channelled into a new form of investment. But if you placed a ceiling on it—and I believe all the plans that have been suggested do envisage a ceiling—it seems to me it cuts down that difficulty very considerably.

May I just add a word on that one point. It does seem to me hardly a valid objection for the minister to raise that difficulty in the way of making a tax exemption for payments into pension funds by self-employed persons, when in fact he does not appear to view with alarm the present situation with respect to the investment of pension plan funds which are established for employees. In other words, the point I am trying to make is that the pension funds established under an employer-employee relation on which there is a tax exemption are invested now, as I understand it—certainly a great majority of them are—in interest-bearing securities. I should doubt very much whether any one of these approved plans would be open to investment in equity capital or common stocks. If the minister is prepared to contemplate that form of investment in interest-bearing securities, then why is he so horrified at the idea that this type of pension plan might also have its funds invested in non-equity capital? It seems that what is fair for one is fair for the other, and the difficulty is greatly diminished when you realize and place on the new proposal the same relative ceiling that now applies to the old one.

* * *

Mr. Abbott: . . . I do not think I shall attempt to discuss this admittedly very difficult problem any further today. He has raised one or two very relative points. If such a plan as he was discussing were to be introduced it would be necessary to impose a ceiling. I think what we would ask is double the present ceiling, because the self-employed would be providing not only his own contribution but the employer's contribution as well.

With respect to the question of trustee funds, I am told that in the United States some of them are now deciding to invest the pension funds in equities. There are all

these factors; but the problem which has caused me the great difficulty is what particular type of savings we would single out for this tax postponement. I tried to make clear in my statement that the discrimination against the self-saver is not as great as it might appear to be on the surface. I hope we shall have a further discussion about this at some other time. The purpose of my statement was to put forward certain considerations which I believe are very relevant to this matter, and that they should be subject to careful and serious critical analysis.

Professional Notes

ALBERTA

Williams & Stuart, Chartered Accountants, announce the termination of their partnership. Henceforth practice of the profession at 513 Lougheed Bldg., Calgary, will be carried by Mr J. D. Williams, C.A. in partnership with Messrs Lorne R. Roberts, C.A. and Harold G. Gibson, C.A. under the firm name of Williams, Roberts & Co., Chartered Accountants. The practice now conducted at Lacombe, Ponoka, and Red Deer will henceforth be carried on by Mr Duncan Stuart, C.A. in partnership with Mr Harry V. Lindskog, B.Com., C.A. under the firm name of Stuart & Lindskog, Chartered Accountants.

NEWFOUNDLAND

C.A. Students Association of Newfoundland

The C.A. students of Newfoundland recently established their own students' association. The first officers and council elected are as follows: *president,* R. Davis; *vice-president* R. Leith, Jr.; *treasurer,* J. Conway; *secretary,* R. Elliott; *member of council,* C. Earle. G. L. Kennedy and J. Marshall were appointed auditors.

ONTARIO

Hamilton and District C.A. Association

The Hamilton and District C.A. Association and the Hamilton Control of the Controllers Institute of America held a joint dinner meeting at the Royal Connaught Hotel on Thursday, April 9. J. L. Pierce, vice-president and controller of the A. B. Dick Company, Chicago, spoke on the contrast between accounting and controllership. Malcolm Sutherland and Herbert Elwell acted as co-chairman. The speaker was introduced by J. M. Thompson and was thanked by C. K. MacGillivray.

Chagnon & MacGillivray, Chartered Accountants, Pigott Bldg., Hamilton, announce the admission to partnership of Messrs Joel A. Hartwell, C.A. and Patrick T. Hunt, C.A.

Ontario Institute

The Institute of Chartered Accountants of Ontario held a reception for the 19 newly elected Fellows of the Institute at the National Club in Toronto on Wednesday, May 20, 1953. The following members received their F.C.A. certificates from the president, Mr. B. A. Armstrong: G. W. Benson, R. C. Bertram, M. A. Bradshaw, F. H. Buck, J. H. Collins, J. A. D. Craig, G. R. Ferguson, H. N. Jordan, G P. Keeping, T. C. Kinnear, H. R. Macdonald, A. S. Merrikin, J. W. Monteith, C. K. MacGillivray, W. H. Rea, G. G. Richardson, T. B. Robson, G. H. Spence, F. S. Vanstone.

* * *

E. M. Sprackman & Co., Chartered Accountants, announce the admission to partnership of Messrs Chester H. Sprackman, C.A., Edel C. Direnfeld, C.A., and Joseph Sprackman, B.Com., C.A. Henceforth practice of the profession will be carried on under the firm name of Sprackman, Direnfeld & Co., Chartered Accountants, 460 Richmond St. W., Toronto.

QUEBEC

Stevenson, Walker, Knowles & Company, Chartered Accountants, Bank of Nova Scotia Bldg., Montreal, announce the admission to partnership of Mr James H. Yates, C.A.

* * *

Mr George R. Graham, C.A. announces the opening of an office for the practice of his profession at the Aldred Bldg., Place d'Armes, Montreal.

QUEBEC

Mr I. Blackman, B.Com., C.A. announces the admission to partnership of Mr A. David Hubscher, C.A. Henceforth practice of the profession will be carried on under the firm name of Blackman & Hubscher, Chartered Accountants, with offices at 1625 Sherbrooke St. W., Montreal.

* * *

Messrs Israel Messinger, B.Com., C.A., Isadore Ferstman, C.A., and Philip Shuster, C.A. announce the formation of a partnership for the practice of their profession under the firm name of Messinger, Ferstman & Shuster, Chartered Accountants, with offices at 627 Dorchester St. W., Montreal.

Price, Waterhouse & Co., Chartered Accountants, 215 St. James St. W., Montreal, announce the admission to partnership of Messrs M. Ogden Haskell, C.A. and A. Willard Hamilton, C.A., formerly of Haskell, Elderkin & Co., Chartered Accountants. Henceforth the practice of Haskell, Elderkin & Co. will be conducted under the name of Price, Waterhouse & Co.

SASKATCHEWAN

Rooke, Thomas & Co., Chartered Accountants, Leader Bldg., Regina, announce the admission to partnership of Messrs C. F. Westerman, C.A., Harold Kay, C.A., and J. K. McLarty, C.A.

News of Our Members

Mr J. W. Adams, C.A. (Ont.), has been made a director of Empire Brass Mfg. Co. Ltd., London, Ont.

* * *

Mr R. D. Armstrong, C.A. (Ont.), became associate comptroller of the Canadian National Railways, effective June 1.

* * *

The Hudson's Bay Co., Winnipeg, has announced the election of Mr H. A. Benson, C.A. (Ont.), as a member of its board of directors.

Mr Charles J. Ferber, C.A. (Sask., B.C.), was appointed by order in council as comptroller-general for the B.C. government service.

* * *

The new chairman of the board of governors of the Canadian Tax Foundation is Mr T. A. M. Hutchison, F.C.A. (Ont.), C.A. (Alta.).

* * *

Mr Robert B. Moran, C.A. (Ont.), is the newly elected president of Shaw & Begg Ltd., Toronto.

Accounting Research

Reports of Studies by
The C.I.C.A. Research Department

AN ANALYSIS OF PRESENTATION TECHNIQUES IN ANNUAL FINANCIAL REPORTS

IV. SURPLUS*

SECTION 112(c) of the Companies Act 1934 (Canada) spells out in detail the requirements as to the presentation of capital surplus, distributable surplus and earned surplus in the annual financial statements to be submitted to the shareholders of a limited company.

Bulletin No. 1, of the Committee on Accounting and Auditing Research of The Canadian Institute of Chartered Accountants, issued in October 1946, contains these recommendations:

> "The changes in the surplus accounts during the year should be clearly stated."
>
> "Earned surplus should be shown separately and it is desirable that the description of capital or other special surplus accounts should indicate their origin."

While a substantial proportion of companies follow the recommended standards of disclosure, the analysis of 1949, 1950, and 1951 published financial statements discloses the existence of a wide range of deviations.

Presentation of Changes in Surplus During the Year

While all financial statements showed the details of the changes in surplus during the year, figure no. 1 shows that the majority set out this information either in a separate statement or in a "combined" statement of earned surplus and profit and loss.

Figure 1

CHANGES IN SURPLUS AS SET OUT IN FINANCIAL REPORTS

1951	1950	1949	
70%	62%	62%	— in a separate statement
26%	35%	34%	— a combined surplus and profit and loss statement
4%	3%	4%	— on balance sheet

* The first three articles in this series, appearing in the March, April and May issues respectively, dealt with balance sheet items and statements of profit and loss.

Balance Sheet Presentation

Shareholders' Equity Figure

Our review showed that 64% of the 1951 statements, 60% of the 1950, and 59% of the 1949 statements included surplus figures separately under the capital caption, thereby setting out as one amount the shareholders' equity in the company. However, 36% in 1951, 40% in 1950, and 41% in 1949 extended the various surplus figures as separate figures under separate captions. In these latter statements it was necessary for the reader to add at least two figures together to arrive at the amount of the shareholders' equity.

In all instances in which the company had an accumulated deficit from operations, the deficit was deducted from the capital figure and the shareholders' equity extended net.

Terminology re Earned Surplus

"Earned surplus" appears to be the most popular description of accumulated earnings. Figure no. 2 sets out the various titles used in this respect.

Capital and Other Special Surplus

Miscellaneous surplus accounts set out separately on the balance sheet included capital surplus, capital surplus arising from purchase of preferred shares for redemption and cancellation, surplus arising from acquisition of shares of subsidiary companies, refundable portion of excess profits taxes, tax paid undistributed income, appraisal surplus resulting from appraisal of fixed assets, premium on shares issued, distributable surplus, etc.

In most instances the description of the miscellaneous surplus account clearly indicated its nature and origin.

Reserves Included in Capital and Surplus Section

On analysis of the balance sheets for years 1951, 1950 and 1949, it was noted that many companies set out separately a wide variety of *properly* classified reserves such as general reserves, contingency reserve, reserve for possible future decline in inventory values, reserves for future plant extension, preferred stock purchase reserve, preferred dividend maintenance reserve, etc. However, only 11.5% of the statements concerned set out these reserves as part of the shareholders' equity.

It will be very interesting in future analyses to watch for the impact of Bulletin No. 9, issued in January 1953, which states: "Since reserves are segregations of earned surplus it is desirable that they be shown on financial statements as constituting part of the shareholders' equity."

Figure 2

1951	1950	1949	Title
223	165	161	Earned surplus
28	21	24	Surplus
19	14	7	Earnings/income/profits retained and employed in the business
5	6	7	Miscellaneous
4	3	3	Deficit
279	209	202	

Figure 3

1951	1950	1949	Dividends set out in surplus
26	13	12	no dividends
126	85	73	all one class
118	103	102	each class shown separately
9	8	15	all classes grouped
279	209	202	

Details of Changes in Surplus Account During the Year

Dividends

Figure no. 3 sets out the summary of the treatment of dividends paid or declared in the financial statements.

In the 1951 financial statements, 81 spelled out the dividend rate in the surplus statement, 84 in directors' report only, and 88 did not show a dividend rate.

Items Other Than Dividends

The following items, by reason of their size or nature, were set out separately as adjustments of the surplus account: profit and loss on disposal of fixed assets and/or investments; prior years' adjustment; refund of excess profits tax; transfer to capital surplus re redemption of capital stock; transfer to or from reserves; tax adjustments prior years; premium and/or expenses re issue and/or redemption of preferred shares; bond issue and/or redemption expenses and/or discount; write off of intangibles — goodwill, organization expenses, and financing expenses; past service pension contribution; sundry adjustments; transfer re s. 95 of the Income Tax Act; adjustment re CSV life insurance, etc.

Insignificant Items Set Out Separately

It is rather difficult to discern why the following insignificant items were disclosed in the surplus accounts as separate amounts:

		Net Profit for the Year
Accident insurance claim adjustment	$ 20.08	$ 50,940
Profit on sale of investments	43.25	388,000
Adjustment provincial taxes	.38	4,138
Profit realized on sale of equipment	3.70	79,528
Adjustment of reserve for income taxes	28.30	79,528
Collection of accounts receivable fully provided for at the inception of the company (in capital surplus)	153.00	248,606
Net adjustment of taxes on income (current provision for taxes on P & L $244,734)	128.26	224,482
Transfer of unclaimed dividends	234.66	564,460

The inclusion of any of these items in the statement of profit and loss would certainly not distort the results of current operations.

Items Which Might Better be Shown in the Profit and Loss Statement

In scrutinizing the changes set out in the surplus accounts in the 1951 statements, a few companies included in surplus specific items which, by reason of their nature, apparently should have been taken into account in determining the net profit from current operations.

Five companies included life insurance premiums paid, three included pension fund past service contributions, three included provision for income taxes, one included provision of vacation pay liability less consequent reduction in taxes on income, and one included an adjustment of prior years' depreciation which amounted to approximately 1% of the annual provision as set out in the profit and loss statement.

AN EYE FOR A FIGURE

A dress house advertised for a model with bookkeeping experience. Three young ladies appeared for the interview. There was one test question: "How much is the total of 8, 7, 6, 5, 4, 3, 2, 1?"

One girl answered 41. Another answered 31. The third girl said 36. After the young ladies had left, the senior partner asked, "Which one shall we take? Perhaps the girl who said 31 would be good for making up our income tax returns."

The junior partner said, "Maybe the girl who said 41 would be good for sending out our invoices."

Turning to their auditor who was present during the interview, the partners asked, "Which one shall we take?"

With a twinkle in his eye the auditor replied, "Take the girl with the perfect 36!"

— ***Submitted by M. Goodman, Montreal***

The Students' Department

J. E. Smyth, C.A., Editor

NOTES AND COMMENTS

A RECENT book on the taxation of income in Canada contains a statement which we think merits further analysis. The author says, "The traditional practice of valuing inventories at the lower of cost or market value is based upon a first-in first-out presumption. This rule, which has always been allowed in Canada, is a concession from the criterion of strict realization. It allows a shifting of the valuation basis from one method of costing to another in accordance with the ups and downs of the price level. It is biased in favour of the taxpayer and against the treasury because it allows for the deduction of unrealized losses, while it does not give corresponding recognition of accrued gains."

The point is a difficult one, but we respectfully dissent if the statement is meant to suggest that *over a number of years* the income reported on a straight "cost" basis of inventory valuation would be substantially higher than the income for the same firm measured on a "lower of cost or market" basis. We submit that if one takes a period of time embracing a complete cycle of upswing and downswing in prices, the total income for the period will be the same by either method of inventory valuation. The income *year by year* may be different but the *aggregate* income over the period of years will be the same.

To our way of thinking the essential point is this: an overstatement of year end inventory admittedly results in an overstatement of income for the year in question; but in the mechanics of measuring income the inventory overstatement has exactly the opposite effect on the income of the following year. This is so because the closing inventory of one year is necessarily the opening inventory of the following year.

Inventory valuations affect income through the calculation of cost of goods sold (one of the most important of expenses). Perhaps we can make our point clearer by looking at an equation defining cost of goods sold. For any year,

cost of goods sold = cost of opening inventory + cost of goods purchased (or manufactured) — cost of closing inventory.

It will be noted that both opening and closing inventory valuations affect the calculation but in opposite directions — opening inventory is added, closing inventory is deducted.

* * * * *

By way of further illustration we have prepared a schedule covering a period of ten years. The data in the first five columns may be taken as given; the data in the sixth column are derived from the given data, and the calculations are shown in a second schedule below.

At the beginning and end of the ten year period prices are stable (cost= market). Prices are rising from years 2 - 5 inclusive (cost is less than market). Prices are falling from years 6 - 9 inclusive (market is less than cost). For

years 2 - 5 inventory valuation at the lower of cost or market is the same as inventory valuation at cost, but this is not so for years 6 - 9.

We draw attention especially to the fact that in our schedule total income for the ten year period is the same whether inventory is valued at the lower of cost or market or at cost.

Comparison of income where inventory is valued at the lower of cost or market with income where inventory is valued at cost over a period of rising and falling prices

	Year end inventory			Reported	Revised
			Lower of cost	income	income
Year	Cost	Market	or market	(L.C.M. basis)	(cost basis)
1	$3,200	$3,200	$3,200	$23,000	$23,000
2	3,400	3,650	3,400	29,000	29,000
3	4,100	4,340	4,100	34,000	34,000
4	3,800	4,100	3,800	37,000	37,000
5	2,600	2,850	2,600	40,000	40,000
6	3,000	2,900	2,900	36,000	36,100
7	3,300	3,000	3,000	35,000	35,200
8	2,800	2,100	2,100	30,000	30,400
9	2,900	2,400	2,400	21,000	20,800
10	2,400	2,400	2,400	22,000	21,500
				$307,000	$307,000

Calculation of Revised Income for the ten year period (assuming "cost" rather than "lower of cost or market" is the correct method of valuing inventory)

Year 6

Reported income (lower of cost or market basis)		$36,000	
Opening inventory — correctly stated, cost	$2,600		
Closing inventory — understated $3,000 - $2,900 =	$100		
Cost of goods sold — overstated	$100		
Reported income understated		100	
Revised income (cost basis)			$36,100

Year 7

Reported income (L.C. M. basis)		$35,000	
Opening inventory — understated $3,000 - $2,900 =	$100		
Closing inventory — understated $3,300 - $3,000 =	$300		
Cost of goods sold — overstated	$200		
Reported income understated		200	
Revised income (cost basis)			$35,200

Year 8			
Reported income (L.C.M. basis)		$30,000	
Opening inventory — understated $3,300 - $3,000 =	$300		
Closing inventory — understated $2,800 - $2,100 =	$700		
Cost of goods sold — overstated	$400		
Reported income understated		400	
Revised income (cost basis)			$30,400
Year 9			
Reported income (L.C.M. basis)		$21,000	
Opening inventory — understated $2,800 - $2,100 =	$700		
Closing inventory — understated $2,900 - $2,400 =	$500		
Cost of goods sold — understated	$200		
Reported income overstated		200	
Revised income (cost basis)			$20,800
Year 10			
Reported income (L.C.M. basis)		$22,000	
Opening inventory — understated $2,900 - $2,400 =	$500		
Closing inventory — correctly stated, cost $2,400			
Cost of goods sold — understated	$500		
Reported income overstated		500	
Revised income (cost basis)			$21,500

* * * *

PUZZLE

Find the digits to correspond with the letters and asterisks in the following multiplication:

```
      m a n
      n o w
    -------
    m * * *
    p e p
* o * m
m a s t e r
-----------
```

(*submitted by a Toronto reader*)

SOLUTION TO THE MAY PUZZLE

Let \$x = the price Alfred originally paid for the motorcycle.

Then, $x \cdot \frac{5}{4} \cdot \frac{9}{10} \cdot \frac{4}{3} \cdot \frac{4}{5} = (x + 8)$

and $x = 40$

Alfred gave \$40 for the motorcycle originally.

PROBLEMS AND SOLUTIONS

PROBLEM 1

Final Examination, October 1952

Accounting I, Question 4 (10 marks)

What are the uses of the information which is produced by the detailed time records maintained by many firms of chartered accountants?

A SOLUTION

Uses of time records kept by firms of chartered accountants

1. Payment of bonus or overtime to staff.
2. Billings to clients. Billings may be made directly on an hourly basis or at a fixed fee. In the latter case, time records make it possible to compare the cost of staff time with the fixed fee.
3. Control over staff. Time records show the time spent on various aspects of work, and indicate whether all members of staff are getting adequate experience. They provide a basis for rating the efficiency of the different staff members and for determining whether the relative time spent by junior and senior staff on a particular assignment is the most efficient allocation of their time. Time records also disclose idle and non-productive time costs.
4. Budgeting of time and scheduling of audits.

EXAMINER'S COMMENTS

Most candidates could produce a reasonably satisfactory answer if they approached the question as a cost question. Some showed very little practical acquaintance with the uses of time records.

PROBLEM 2

Final Examination, October 1952

Accounting I, Question 5 (10 marks)

Name six considerations which the directors of a limited company should take into account in considering whether or not to declare a dividend.

A SOLUTION

Considerations to take into account in declaring a dividend

(1) Is the proposed dividend legal according to the *Companies Act* under which the company is incorporated? See, for example, section 83 of the Dominion *Companies Act.*

(2) Is there sufficient cash and working capital available?

(3) Do the earnings for the year, and the accumulated earnings, justify the proposed dividend?

(4) Has the company endeavoured in the past to maintain a stable dividend policy?

(5) Has the earnings record of the company been fairly stable?

(6) Would the proposed dividend be possible only because of an unusual gain, such as a profit on the disposal of investments?

(7) To what extent may funds be required for future expansion?

(8) What are the income tax implications for shareholders receiving the dividend? See, for example, Part IA of the *Income Tax Act,* and the rate of tax on the shareholders.

(9) What are the income tax provisions and the foreign exchange regulations concerning the payment of a dividend to foreign investors?

(10) Are there conditions (e.g. trust agreements) attached to the preferred shares or other senior securities?

EXAMINER'S COMMENTS

Many candidates underestimated the question and quickly composed an answer without having arranged their thoughts properly. Some placed too much emphasis on one or two points. When asked for six "considerations" a number of candidates split one general point into three or four parts, viz., (1) Would the dividend render the company insolvent? (2) Is it legal? (3) Does it result in an impairment of capital? and (4) Is the company solvent? These are all essentially the same point.

PROBLEM 3

Final Examination, October 1952

Accounting I, Question 6 (25 marks)

The D. Co. Ltd. operates a soft drink bottling plant. There are three departments — mixing, bottling and packing. You are given the following information in respect of its operations for the year 1951:

(a) Inventories

	Jan 1 1951	Dec 31 1951
Raw materials—ingredients	$3,970	$5,948
Gallons in mixing dept.		
Ready for bottlings	25,400 gals @ 54.22c—$13,772	15,905 gals.
Finished stock	9,100 gals @ 89c — 8,099	17,103 gals.

(b) Expenditures (as extracted from the accounts):

Ingredients purchased	$47,920
Bottles	20,890
Labels	3,340
Bottle caps	2,220
Cartons	6,450
Direct wages — Mixing	29,400
— Bottling	8,400
— Packing	4,200
Factory supervision	10,500
Departmental expenses — Mixing	3,890
— Bottling	2,880
— Packing	1,970
Factory occupancy	18,400
General factory service expense	24,500
Sales tax	20,487
Shipping wages	3,760
Interest and bank charges	6,140
Outward freight	1,500
Delivery expenses	3,320
Selling expenses	7,580
Administrative expenses	13,760

(c) Depreciation on machinery is to be provided at 10% per annum on cost.

(d) All ingredients are added at the commencement of the mixing process.

(e) Shrinkage in bottling—2% of gallons received.

(f) Sales—204,872 gallons—$257,145.
(g) Income taxes to be calculated at 25%.
(h) Departmental data—

	Space Occupied	Machinery (at cost)
Mixing	1,500 sq. ft.	$19,900
Bottling	1,500 sq. ft.	28,700
Packing	1,000 sq. ft.	....
	4,000 sq. ft.	$48,600

Required:
Statements to show:
(a) Production costs by departments,
(b) Total departmental costs per gallon, and
(c) Trading and profit and loss for the year.

NOTE: All calculations, except cents per gallon, are to be carried to the nearest dollar.

A SOLUTION

D. CO. LTD.

Cost of Production

for the year ended 31 Dec 1951

	Basis of Distribution	Mixing	Bottling	Packing	Total
Materials (Schedule 1)	Direct	$ 45,942	$ 26,450	$ 6,450	$ 78,842
Direct wages	Direct	29,400	8,400	4,200	42,000
Factory supervision	Direct wages	7,350	2,100	1,050	10,500
Departmental expenses	Direct	3,890	2,880	1,970	8,740
Factory occupancy	Space occupied	6,900	6,900	4,600	18,400
General factory overhead	Direct wages	17,150	4,900	2,450	24,500
Depreciation	Machinery	1,990	2,870	—	4,860
Total departmental costs		$112,622	$ 54,500	$ 20,720	$187,842
Opening inventory of work in process		13,772	—	—	13,772
		126,394			201,614
Received from Process Department (Schedule 2)		—	117,771	172,271	
Cost after Department		$126,394	$172,271	$192,991	
Less closing inventory of work in process*					8,623
Cost of finished stock manufactured					$192,991

* 15,905 gals. at 54.217c per statement of departmental costs per gallon, below.

D. CO. LTD.

TOTAL DEPARTMENTAL COSTS PER GALLON
for the year ended 31 Dec 1951

Gallons	Mixing	Bottling	Packing
Opening inventory work in process	25,400	——	——
Production (Schedule 3)	207,724	212,875	212,875
Lost in process (Schedule 3)	——	4,344	——
	233,124	217,219	212,875
Transferred to next department (Schedule 3)	217,219	212,875	212,875
Inventory work in process	15,905	——	——
	233,124	212,875	212,875
		(x)	
Gallon cost in department	54.217c	26.708c	9.733c
Gallon cost after department	54.217c	80.925c	90.658c

(x)

Cost in bottling department $= \dfrac{\$54{,}500}{212{,}875} =$ 25.602c

Loss in production $= \dfrac{4{,}344 \times 54.217c}{212{,}875} = \dfrac{\$2{,}355}{212{,}875} =$ 1.106c

26.708c

D. CO. LTD.

PROFIT AND LOSS STATEMENT
for the year ended 31st Dec 1951

Sales for the year	$257,145
Less sales tax	20,487
Net sales	$236,658
Cost of sales	
Opening inventory — 1 Jan 1951	$ 8,099
Goods manufactured	192,991
	201,090
Less inventory — 31 Dec 1951	15,505
Cost of sales	185,585
Gross trading margin	$ 51,073
Selling expenses	
Shipping wages	$ 3,760
Outward freight	1,500
Delivery expenses	3,320
Selling expenses	7,580
	16,160

Administrative expenses	
Administrative expense	13,760
Interest and bank charges	6,140
	19,900
Total selling and administrative expenses	36,060
Net margin before income taxes	15,013
Income taxes	3,753
Profit for year	$ 11,260

Schedule 1

COST OF MATERIALS USED
for the year ended 31st Dec 1951

Mixing Department (ingredients)	
Inventory — 1 Jan 1951	$ 3,970
Purchased	47,920
	51,890
Less Inventory — 31 Dec 1951	5,948
Ingredients used	$ 45,942
Bottling Department	
Bottles	$ 20,890
Labels	3,340
Crowns	2,220
	$ 26,450
Packing Department	
Cartons	$ 6,450

Schedule 2

COSTS TRANSFERRED TO NEXT DEPARTMENT

	Mixing	Bottling	Packing
Cost after department (per statement of cost of production)	$126,394	$172,271	$192,991
Inventory in process in department	8,623	—	—
Costs transferred to next department	$117,771	$172,271	$192,991

Schedule 3

VOLUME OF PRODUCTION
for the year ended 31 Dec 1951

Gallons sold	204,872	gals.
Plus Inventory — 31st Dec 1951	17,103	
	221,975	
Less Inventory — 1st Jan 1951	9,100	
Gallons bottled and packed	212,875	
Shrinkage in bottling — 2/98 of 212,875	4,344	
Gallons received in bottling	217,219	
Add Inventory — 31st Dec 1951 — mixed	15,905	
	233,124	
Less Inventory — 1st Jan 1951 — mixed	25,400	
Gallons mixed	207,724	gals.

EXAMINER'S COMMENTS

Many candidates experienced difficulty with the treatment of sales tax. Also, many candidates used area rather than direct labour as the basis for distributing general factory service expense and supervision. There was general difficulty in handling the shrinkage problem. Some students had trouble reconciling the production (gallonage) figures.